

technology from BOC to BOC. Nevertheless, if the Bureau is inclined to make such comparisons, the Bureau will see that BellSouth's incremental-based rates are generally in the low to mid-range as compared with other BOCs' rates, whereas BellSouth's average-based rates would be in the high range as compared with other BOCs' rates.³¹

In light of the above, it cannot be concluded that BellSouth's use of incremental costs has resulted in "excessive" rates. Indeed, it appears that incremental-based rates established using BellSouth's methodology are lower, on the average, than averaged-based rates.³²

d. Policy Against Discriminatory Pricing

Another of the Commission's ONA goals is to protect against discriminatory pricing. Presumably, there are two bases for this goal: 1) to protect against predatory pricing, and 2) to protect against the establishment of rates for BSEs use by BOCs at more favorable rates than BSEs not used by BOCs.

As discussed previously, the Commission has already determined that the use of the net revenue test, which

³¹ For example, whereas BellSouth's incremental-based rates for ANI are the second lowest of the seven BOCs, the fictional average-based rates would be the third highest among the seven BOCs. See Exhibit D.

³² As Exhibit E shows, the average-based rates would result in the recovery of revenues at a level 21.0% higher than the filed revenues. In arriving at this calculation, BellSouth excluded the rate changes for the unbundled BSEs in light of the revenue neutrality requirement imposed by the Commission for such BSEs.

compares incremental revenues to incremental costs, is sufficient to protect against predatory pricing. This is a correct analysis which assures that a new service at a minimum recovers the costs it causes.

As to discriminatory pricing, the focus should not be upon the relationship between one BOC's rates to another's rates. Rather, the Bureau should focus upon whether each given BOC has established rates for each of its BSEs in a non-discriminatory fashion with respect to its other BSEs. Thus, the Bureau is appropriately inquiring into the manner in which costs were loaded by each BOC to arrive at BSE rates. This is consistent with the Commission's requirement that non-uniform loadings would be allowed but must be explained, and is further discussed in Section IV, infra.

Clearly, the use of incremental costs, identified in a consistent manner across all of a given BOC's BSEs, and the application of uniform loadings thereupon is not discriminatory.

3. Rates Based Upon Average Basis Assumption Within The SCIS Model.

As a part of Issue 1, the Bureau requires BellSouth to provide "comprehensive alternative BSE rates that reflect use of the average basis assumption within the SCIS model." As discussed in preceding sections, an average cost analysis allocates costs to services in an arbitrary fashion. Average costs are unrelated to the costs caused by a service and, thus, have no rational relationship to the rate-setting

process. For all of the reasons discussed in the preceding sections of this Direct Case, the Bureau should not require that BSEs, or any new service, be priced in relationship to average costs.

Nevertheless, given the Bureau's mandate, BellSouth has developed "average-based" rates. Because BellSouth would not have developed "average-based" rates absent the Bureau's requirement, and because of the inherently arbitrary manner in which an average cost approach loads costs onto a service, there is no methodology which would achieve average-based rates which are either economically correct or rational. In order to meet the Bureau's requirement, however, BellSouth developed the rates using an analogous methodology to that used to identify the marginal-based rates. Average investment was identified using the SCIS average option,³³ and average costs were developed from the resulting investment using the same methodology used to calculate marginal costs from marginal investments.³⁴ A loadings ratio was identified using a local switching

³³ BellSouth used the SCIS average option to first develop an average model office. The unit investment outputs from these average runs were then used in the calculation of average investments. As previously discussed, these results reflect the allocation of under-utilized processor capacity.

³⁴ The resulting costs are shown on Exhibit B.

"average-based" loadings factor.³⁵ Although not required to do so, BellSouth established the rates at a level equal to average costs times the local switching average-based loadings factor, given that the incremental rates had been established in the same manner. The resulting "average-based" rates are provided as a part of this Direct Case as Exhibit C.³⁶ The resulting "average-based" rates are provided as a part of this Direct Case as Exhibit C.

As can be seen, the "average-based" rates do not show the same change from incremental-based rates across all of BellSouth's BSEs. The "average-based" rates are as much as 609.38% higher than the incremental-based rates, and in some cases are as much as 10.67% lower. This is due to the fact that the relationship between incremental costs to average costs can vary from BSE to BSE. One reason for this is that

³⁵ The local switching loadings factor methodology is discussed in more detail in Section IV, infra. In brief, the "average-based" loadings factor was developed in the same manner as the filed local switching loadings factor, with the exception that the former used a comparison of total local switching average costs to total local switching revenues and the latter used a comparison of total local switching incremental costs to total local switching revenues.

³⁶ As BellSouth explains in Section IV., the Commission's rules do not require that rates be established using any particular loadings methodology or that the loadings be the same for each service. Given the permitted flexibility, were the Bureau to impose a requirement that BellSouth must establish rates based upon average costs, the loadings of the actual rates chosen by BellSouth could be anywhere between no less than the incremental cost price floor and no more than a just and reasonable amount of loadings.

the underutilization of the processors varies based upon the technology used, and the technology used varies for some of the BSEs. Also, the relationship between processor costs and other switching costs often varies among the BSEs.

B. ISSUE 2 - Selection of Model Offices

The second set of issues designated for investigation by the Commission is described as follows:

2) Have carriers selected model offices that are representative of offices that will be used to provide BSEs?

For each switching office and remote included in the carriers' investment cost studies, the carriers should provide on the record the corresponding assumptions regarding switch replacement schedule, and switch capacity at replacement, that are used as inputs to develop the SCIS "model office."

It is unclear whether carriers have included all switching offices and remotes in the data used by SCIS to establish the model offices from which SCIS develops cost data for vertical service functions. Therefore, carriers are directed to state in their direct cases whether all switching offices and remotes are included in their model offices and, if not, to describe the methods used to select the facilities represented in the model office. If statistical sampling techniques have been used to develop a model office, the carrier should describe in detail the techniques used.

BellSouth identified as the switch investment associated with its BSEs that investment which is consistent with a forward-looking incremental cost analysis. Because BellSouth is deploying only digital switch investment on a going-forward basis, only digital switch investment was included. As a consequence, the incremental investment is

not representative of embedded investment.³⁷ Both host and remote switches were included, and statistical sampling was not performed to identify any subset of offices within the switch type to be included in the model office calculations.

With Exhibit F, attached hereto, BellSouth provides the assumptions regarding switch replacement schedule and switch capacity at replacement³⁸ that are used as inputs to develop the SCIS "model office." Included are data showing percent utilization at replacement ("PUR") and number of years to replacement ("NYR").

In reviewing this data, it is important to keep in mind that central office requirements other than processor utilization can trigger office replacement. For instance, the number of line terminations, memory requirements, and usage levels all have the potential to exhaust the switch and lead to scheduling replacement when available processor capacity still exists. Furthermore, replacement schedules are dynamic. Factors other than utilization can and do impact the scheduling of switch replacement. For instance, timing of switch replacements can be in direct response to federal and state directives to upgrade the network and

³⁷ This is appropriate, as is discussed in BellSouth comments on Issue 4, below, because a consideration of embedded investment would form an inappropriate basis for determining the price floor.

³⁸ It should be noted that processor utilization and replacement date information is not entered on a remote level. This is because remotes do not have processors, but are linked to the host office where the processing occurs.

provide the latest innovations. The Commission's access time standard requirements in its 800 Database proceeding are causing BellSouth to advance the deployment of equipment with SSP and CCSAC capabilities.³⁹ Additionally, the Tennessee Public Service Commission has initiated an effort to equip central offices with ISDN.⁴⁰ This would require the advancement of analog replacements in the state.

Additionally, market conditions and demand impact the replacement schedule. If a the market is demanding services requiring digital capabilities, the company may decide, after proper economic analysis, to advance the replacement of an analog office in order to maintain its competitiveness. Positioning for future switch enhancements impacts the replacement schedule. For example, the anticipated future of switching is via an optical medium which can be supported only by digital technology. In order to position the network to be primed for optical capabilities, digital switches must be in place since analog switches do not have an optical interface. The company, after prudent economic study, may decide to advance the

³⁹ See Provision of Access for 800 Service, CC Docket No. 86-10, BellSouth Telecommunications, Inc. Petition for Waiver, filed February 28, 1992.

⁴⁰ See Telecommunications Technology Deployment Analysis and Master Plan Development, Docket No. 90-06255, approved by Tennessee Public Service Commission, December 1990.

placement of digital offices to provide a platform for future network capabilities.⁴¹

C. ISSUE 3 - Cost of Money

(3) Is use of a cost of money that exceeds 11.25 percent reasonable?

Carriers that used a cost of money in excess of the authorized 11.25 percent rate of return, either as a SCIS variable or at any other point in the ratemaking process, must explain why the use of such a "cost of money" will not produce excessive BSE rates.

BellSouth utilized a cost of money of 13.52% in developing incremental costs.⁴² The cost of money is designed to reflect the expectations of the investor as well as the cost of borrowed money. The 13.52% level is BellSouth's view of the long-run incremental cost of money and is consistent with BellSouth's use of a long-run incremental cost analysis.

The use of a cost of money higher than the 11.25% suggested by the Commission will not "produce excessive BSE rates." The fundamental reason for this is that BSE rates are not equal to incremental costs.⁴³ Rather, the incremental costs of the BSE services are identified to

⁴¹ Because replacement schedules are dynamic, the schedules may well vary depending upon the point in time at which the schedules are captured.

⁴² SCIS does not use a cost of money factor to develop incremental investment where the marginal option is used.

⁴³ Of course, rates for a service could be established at (or just above) incremental costs if a firm chose to do so.

establish a price floor, and rates are established based upon other factors with the only limitation being that no more than a just and reasonable amounts of loadings be applied. Given the flexibility afforded LECs by the Commission under its rules for the pricing of new services, the incremental costs of a service can vary without necessarily affecting rates while at the same time the rates for a service can be held constant even though the incremental costs are varied.

Even assuming that BellSouth should have utilized an 11.25% cost of money instead of the 13.52% it did use, the change in the incremental costs would have been minimal. Furthermore, a change in rates would not necessarily have occurred. Where rates are established to take into account market conditions, a change in a single cost element does not translate automatically into a rate change. Indeed, as long as rates are at or above the price floor, no change in the rate level would be necessitated by a change in an element of cost.

Even where rates are established based upon uniform loadings to incremental costs, a change in the cost of money factor would not change the rates, at least where BellSouth's pricing methodology is used. If BellSouth had utilized an 11.25% cost of money factor, the loading factor which BellSouth developed would have changed accordingly to reflect calculation of the local switching loading factor

using an 11.25% cost of money factor also.⁴⁴ In other words, the incremental costs used to develop the local switching loading factor would also have been calculated using an 11.25% cost of money factor.

Thus, whether loadings are developed using a 13.52% cost of money factor or an 11.25% cost of money factor the resulting rates would have been the same. As with the Bureau's review of BOCs' cost methodologies in general, the focus of the Bureau's investigation should therefore be not on what cost of money level a BOC has chosen, but whether the cost of money factor utilized by each BOC has been incorporated into the BOC's cost development and ratemaking on a consistent basis.

Finally, as indicated previously, the incremental cost of a service does not determine the rate for the service, but rather merely identifies the price floor. An inquiry into whether rates are excessive should focus upon the methodology and theories utilized by the BOC to establish rates once costs have been determined using the BOC's own chosen and consistently applied methodology.

D. ISSUE 4 - Exclusion of 1ESS and/or 1AESS Switching Investment and Costs

(4) Should 1ESS and/or 1AESS switch costs be included in the development of BSE rates?

We direct those carriers that based their BSE rates in part on costs associated with 1ESS switches

⁴⁴ The BellSouth local switching loading factor methodology is described in Section IV, infra.

and 1AESS switches [Ameritech, Bell Atlantic, NYNEX, and Pacific Bell] to explain why including costs for this switching equipment in BSE rate development is reasonable.

Those carriers must provide a comprehensive listing of BSE rates that would be developed excluding these switch technologies. Cost support for these rates should include a quantitative description of the mix of switch technologies assumed. Furthermore, we direct those carriers to demonstrate how embedded switch technology assumptions promote each of the four Commission goals explained in the Part 69 ONA Order. Specifically, those carriers should explain (i) how BOC flexibility to price efficiently is furthered by the assumption of embedded switch technology; (ii) how BOC incentives to innovate are fostered by reliance on the embedded technology assumption; (iii) how reliance on embedded technology costs fosters the Commission's stated goal that BOCs not set rates excessively high; and (iv) how reliance on embedded technology furthers the goal that BOCs not engage in unreasonably discriminatory pricing.

Although BellSouth is not required to respond to this set of issues, BellSouth requests the Bureau to consider the following comments. The investment utilized in a long-run incremental cost analysis are limited to those technologies which will be deployed on a forward-looking basis in the long-run. Where a BOC has a particular switch technology in its embedded base, but is no longer continuing to deploy that technology, it is excluded from a forward-looking analysis. BellSouth is no longer deploying analog switches, such as the 1ESS and the 1AESS, and, therefore, for BellSouth, these switches are not a forward-looking technology. Other BOCs may be continuing to deploy analog switches, however, and, if this is the case, then analog

technology would be consistent with a forward-looking view for that BOC.

The use of embedded investment and embedded costs⁴⁵ is not appropriate in identifying a cost floor for the same reasons that the use of an average approach is incorrect.⁴⁶ Both an average view and an embedded view require the consideration in the cost analysis of costs which were not caused by the provisioning of the service studied. As BellSouth has reiterated throughout this Direct Case, it is economically incorrect to identify a price floor by reference to costs which a new service does not cause. To do so would constrain pricing flexibility and chill innovation in that a BOC would not be permitted to establish rates for a services at the level of costs which the provisioning of the service has caused it to incur.

IV. BELLSOUTH'S METHODOLOGY FOR LOADING DIRECT COSTS TO ESTABLISH RATES IS CONSISTENT WITH THE COMMISSION'S ONA PRICING REQUIREMENTS AND POLICIES.

The Commission's rules for new services under Price Caps allows BOCs to "add an appropriate level of overhead

⁴⁵ "Embedded" in this sense means technology which is not forward-looking. Obviously, as the preceding paragraph indicated, a technology can be both embedded and forward-looking if it is in the embedded base and also is continuing to be deployed.

⁴⁶ An average cost analysis can be either forward-looking or embedded. As BellSouth demonstrated in Section III.A. of this Direct Case, an average cost analysis is not appropriate, and this is the case whether an embedded or a forward-looking view is taken.

costs to derive the overall price of the new service."⁴⁷

The Commission does not require uniform loading, but has indicated that "BOCs will be expected to justify the loading methodology they select as well as any deviations from it."⁴⁸

The Commission has designated for investigation four sets of issues related to the overhead loadings applied by the BOCs, including the extent of the loadings, the uniformity of the loadings and the cost to price ratios of the various BOCs. In the discussion which follows, BellSouth responds to each of these issues, demonstrating that the loadings methodology it has chosen is reasonable and that the resulting rates are not excessive.

It is apparent from the Bureau's questions that it has engaged in a comparison of the loadings of the BOCs in an attempt to evaluate the reasonableness of the various BOCs' loadings and rates. The Bureau should keep in mind that the Commission has not prescribed the particular loadings methodology to be used, nor has it required that loadings be uniform, either from BOC to BOC or within a BOC itself. Inherent in the flexibility permitted is the expectation that a variety of loadings methodologies could be utilized all of which could be reasonable. Thus, the Bureau's focus should be not on the extent to which BOCs' loadings

⁴⁷ ONA Report and Order, para. 44.

⁴⁸ Id.

methodologies or amounts differ, but upon whether the methodology chosen by each given BOC is reasonable.

A. ISSUE 5 - Level of Overhead Loadings

The first set of issues designated for investigation by the Bureau with regard to loadings is as follows:

(5) Are the BellSouth and US West overhead loadings excessive?

Our analysis of overhead loadings, displayed in Attachment A of this Order, reveals that BellSouth and US West apply loadings to their direct costs that significantly exceed the overheads applied by the other carriers and appear excessive. [Note 11: For example, BellSouth applies overheads for BSEs that exceed direct costs by a range of 200 percent (Faster Signaling on DID for Each Additional 20 Numbers) to 221 percent (Multiline Hunt Group - Individual Access to Each Port)....] We direct BellSouth and US West to explain why their overhead loadings are not excessive.

BellSouth developed the prices for its BSEs by applying to each BSE's long-run incremental costs what BellSouth has termed as a "local switching loading factor." As BellSouth explained in its ONA filing, this factor is the ratio of total local switching revenues to total local switching long-run incremental costs. The resulting factor, 3.19, is used to determine the loadings in the following manner: 3.19 times the direct costs, minus the direct costs, equals the loadings.⁴⁹ As BellSouth also indicated in its filing, this loadings methodology does not identify the maximum level at which rates could be set, but merely is a means to

⁴⁹ The amount of the loadings is 2.19 times the direct costs, whereas the resulting rate (the direct costs plus the loadings) is equal to 3.19 times the direct costs.

assure that no more than a just and reasonable amount of loadings are applied. As is discussed in the next section, the loadings factor was applied equally to each BSE, although under the flexible approach adopted by the Commission in its ONA Report and Order, uniform loadings are not required.

While the use of BellSouth's loadings methodology is not the only manner in which direct costs could be loaded, it is a reasonable method. With the application of the local switching loadings factor, rates for the new services are established in the same relationship to their incremental costs as are existing local switching services priced with respect to their incremental costs. Clearly, such loadings cannot be deemed to be excessive if this is the existing relationship of the related, i.e. local switching, Price Cap services.⁵⁰

The Bureau implies that because BellSouth's overhead loadings factor is greater than many of the BOCs, as is shown on Attachment A to the Designation Order, this signifies that BellSouth's loadings are excessive. Such reasoning, however, ignores the fact that loadings factors

⁵⁰ As Exhibit E shows, had BellSouth utilized average costs and loaded the BSEs with a local switching average-based loadings factor, the loadings factor would have been smaller. However, the resulting revenues for the new BSEs would have been 21.0% higher than the filed revenues for the new BSEs which were based upon utilization of a local switching incremental-based loadings factor.

could vary among the BOCs for a variety of reasons, and that a comparison of such factors is not necessarily meaningful.

As a preliminary matter, the BOCs are using different cost methodologies to identify what they term to be "direct costs." While there is nothing, per se, wrong with this, different loadings ratios will necessarily result to obtain the same rate if loadings are applied to a different base, for instance, to embedded costs instead of forward-looking costs or to average costs instead of incremental costs.

Secondly, the BOCs may have differing reasons for the rate levels actually chosen. Nothing in the Commission's rules requires that BOCs establish the same rates or utilize the same level of loadings. BOCs are appropriately permitted, under the Commission's flexible approach, to establish rates at the lowest possible level, as identified by the price floor, or at the highest possible level, as long as the "no more than" just and reasonable loadings result. To require otherwise would destroy the pricing flexibility which is so fundamental to the Price Caps rules, in which "costs" are not the determining factor as they were in the era of revenue requirements. Clearly, just because some BOCs may have chosen to establish BSE rate levels above BellSouth's, or BellSouth's above other BOCs, does not establish that such rates are "excessive."

Thirdly, even if BOCs did not establish rates solely based upon market considerations, but also with reference to

a loadings factor, the loadings methodologies utilized differ. For instance, some BOCs appear to have utilized loadings factors which mix cost methodologies, for instance, embedded, fully distributed annual cost factors and incremental annual costs factors, and have applied the result to costs developed on even another basis, an average cost approach. BellSouth, on the other hand, compared the incremental costs and revenues of the local switching category as a whole and loaded the incremental costs for its BSEs on the same basis.

Fourth, even if the BOCs had all utilized the same methodologies as BellSouth utilized to identify direct costs and loadings, the resulting rates would have varied. Because of differences in the mix of forward-looking technologies among the BOCs, the incremental costs used to develop the local switching loadings factor would be quite different.

Given the many factors which could cause the BOCs' loadings ratios to vary, and, more importantly, given the Commission's policy that methodologies need not be uniform, the Bureau's inquiry should not focus on whether the direct cost to rate ratios vary from BOC to BOC. The mere fact that BOCs have utilized different costing, loadings and pricing methodologies for arriving at their rates for BSEs does not mean that only one methodology is reasonable and all others are unreasonable. Rather, the Bureau should

review the methodologies adopted by each BOC to determine if they are reasonable in and of themselves and applied consistently across all of the BSEs of that BOC. As to BellSouth, the Bureau should conclude that the chosen methodology and the resulting rates are reasonable because they allow BSEs to achieve revenues at the same proportion as the local switching category as a whole.

B. ISSUE 6 - Uniformity of Loadings

The next set of issues designated by the Bureau with regard to loadings is as follows:

Have carriers adequately justified their use of nonuniform overhead loadings in pricing BSEs?

A separate issue arises from the fact that certain carriers do not apply uniform overhead loadings to each of their BSEs. Overhead loadings below the level indicated by adherence to uniform practice, as well as loadings exceeding the uniform practice, are indicated in Attachment A. Those carriers so identified should, in their direct cases, either demonstrate that they have applied uniform overhead loadings, or justify the use of each loading that departs from uniform loadings practice.

Although not required to do so, BellSouth did apply uniform loadings to all of its BSE services. As described in the previous Section, BellSouth developed a local switching loadings factor from the long-run incremental costs and revenues of local switching services and then applied that same factor to the long-run incremental costs of the BSEs to determine the rates.

As Attachment A to the Designation Order shows, there are slight differences in the loadings factors applied to

BellSouth's BSE costs.¹ These differences are not a result of nonuniform loadings but rather are the result of rounding. For instance, to obtain the rate for the first BellSouth BSE shown on Attachment A, Calling Billing Number Delivery (ANI)⁵¹ BellSouth multiplied the incremental cost, \$.00006, by the local switching loadings factor, 3.19. The result, \$.0001914, was rounded to five decimal places to establish a rate of \$.00019.⁵²

As a result of the Bureau's attempt to back into the loadings factor, the effect of the rounding can be seen. It appears that the Bureau compared the total costs of each BSE, i.e. the direct costs plus loadings, to the direct costs of that BSE.⁵³ Once again using Calling Billing Number Delivery (ANI), as an example, the calculation would be as follows: (CHART UNIT LN 9/CHART UNIT LN 7) - 1.00, or

⁵¹ See Attachment A, line 7.

⁵² To say that incremental costs were multiplied by a factor of 3.19 is the same as saying that the incremental costs were increased by 2.19. The 3.19 factor identifies the loadings factor, and the 2.19 identifies the amount of the loadings to be applied to the incremental costs, but whichever is used, the result is the same. For example, assume an incremental cost of \$2.00 for a hypothetical service. The rate after loadings would be \$6.38 under either approach: 3.19 times \$2.00 equals \$6.38, and \$2.00 plus (2.19 times \$2.00) equals \$6.38.

⁵³ Although the note at the bottom of Attachment references as a source "ONA TRP CHART RATIO LN 3/CHART UNIT LN 9," these two amounts are the same, and if this is what the Bureau had compared, the ratios would all be 1.00. The correct source for a comparison of unit costs plus loadings and units costs would be "(CHART UNIT LN 9/CHART UNIT LN 7) MINUS 1.00."

$(\$0.00019/\$0.00006) - 1.00 = 2.1667$. Once the direct costs are loaded back in,⁵⁴ the resulting loadings ratio is 3.1667 instead of the 3.19, a rounding difference of .7%.

C. ISSUE 7 - Comparison of Rate and Cost Ratios

The next set of issues designated by the Bureau with regard to loadings is as follows:

Are differences between BSE rates and unit costs differences justified?

Some BSE rates do not appear to represent the aggregate of direct costs plus overheads. See Attachment B. We direct each carrier, for each ratio between rates and aggregate direct costs (including overheads) that is emphasized in the Attachment, to either demonstrate that the unit costs it used are in fact equivalent to the tariffed rate, or to justify any difference between the rate and the unit costs (direct cost plus overheads).

In Attachment B to the Investigation Order, the Bureau has provided the BOCs' ratios of rate to unit cost (direct costs plus loadings), citing as a source the BOCs TRP CHART RATIO, line 3/CHART UNIT, line 9. The Bureau highlights the rate to unit cost ratios for six of BellSouth's BSE rate elements for which it requires an explanation. These are shown on lines 29, 30, 33, 36, 37 and 40.

The total annual costs and charges for the items on lines 29, 30, 36 and 37 are the same and will be discussed together. The ratio of costs to rates is .80 for these,

⁵⁴ The Bureau is using the amount of the loadings onto direct costs, 2.19, rather than the loadings factor, 3.19.

rather than the expected 1.00,⁵⁵ due to rounding. The total annual cost (direct costs plus loadings) of each of these items is \$.15 per year. Since charges are billed on a monthly basis, this cost must be converted into a monthly cost equating to \$.0125 per month (.15/12). However, BellSouth's billing system is limited to two decimal places for monthly recurring charges.⁵⁶ Therefore, the rate was rounded down to \$.01 per month, or \$.12 per year. This results in an annual rate to annual cost ratio of \$.12/\$.15 = .80, as is shown on Attachment B.

The total annual charges and total annual costs for the BSEs shown on lines 33 and 39 of Attachment B for BellSouth are the same: \$3.84 and \$3.96, respectively. Therefore, the ratio of rates to total costs is .97 for each of these ($3.84/3.96 = .97$). BellSouth has been unable to reconstruct the ratios of .4559 and .0815 which are shown on Attachment B, and it appears that an error has been made in the Bureau's own analysis.

In sum, BellSouth has loaded overhead costs onto the marginal costs of its BSEs in a consistent manner. The differences in cost to rate ratios are not the result of a non-uniform loading and, indeed, are not of a material

⁵⁵ Because BellSouth established rates at the same loadings ratio, one would expect the ratio to be at or near 1.00 as it is for the majority of BellSouth's BSE rate elements.

⁵⁶ This same limitation does not apply to usage-based charges.

nature. Rather such differences are merely the result of rounding.

V. CONCLUSION.

In the foregoing Direct Case, BellSouth has responded to each of the issues designated for investigation in this proceeding. BellSouth has shown that the cost methodology used to develop the price floor for its BSEs, a marginal cost analysis, is the correct economic means for identifying the cost floor and a reasonable approach from a regulatory standpoint. BellSouth has also demonstrated that the loadings methodology utilized is reasonable and consistent with the Commission's requirements and has not resulted in excessive rates.

More importantly, BellSouth has shown that its costing and pricing methodologies are consistent with the flexible cost-based approach which the Commission has determined to be the best means for achieving its goals under ONA. Under this approach, the Commission has afforded BOCs flexibility in establishing rates for new services under the Price Caps rules. Those rules allow for the price floor to be determined by the incremental costs of the service and for any amount of loadings to be applied as long as the just and reasonable standard is met. The Bureau should not and cannot deviate from the flexible cost-based approach adopted by the Commission in its evaluation of BOCs costing and pricing methodologies for their initial ONA access filings.

Given that BellSouth's methodologies and rates are well within the ambits of the approach adopted by the Commission, the Bureau should conclude this investigation in BellSouth's favor without further ado.

Respectfully submitted,

BELLSOUTH TELECOMMUNICATIONS, INC.

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Date: May 18, 1992

1 SOUTHERN BELL TELEPHONE AND TELEGRAPH COMPANY
2 REBUTTAL TESTIMONY OF RICHARD D. EMMERSON
3 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
4 DOCKET NO. 880812-TP
5 SEPTEMBER 1, 1989
6

7 Q1. Please state your name and business address.

8

9 A1. My name is Richard D. Emmerson, I am President of
10 Emmerson Enterprises, Inc. and President of INDETEC
11 Corporation. My business address is 12651 High
12 Bluff Drive, Suite 300, San Diego, CA 92130.

13

14 Q2. What experience and qualifications do you have
15 pertaining to your testimony?

16

17 A2. I have a Ph.D. in economics from the University of
18 California, Santa Barbara; I was a full time member
19 of the economics department at the University of
20 California, San Diego from 1971 through 1979; I
21 have written articles in professional economics
22 journals; I have testified in telephone rate
23 hearings regarding rate structure, cost analyses,
24 and competition in the states of Pennsylvania,
25 Delaware, Kentucky, Minnesota, Arizona, Nevada, and

1 California; I have been Senior Vice President of
2 Criterion Incorporated, President of Econometric
3 Research Associates, Inc., and President of The
4 Institute for Policy Analysis. All of these
5 companies are or have been engaged in economic
6 research for regulated firms, competitive firms,
7 trade associations, and government agencies;
8 including regulatory commissions. Currently, I
9 teach courses on costing and pricing to employees
10 of telephone companies, commission staff members,
11 partners and managers of large accounting firms,
12 and students of the University of California, San
13 Diego.

14

15 Q3. What is the purpose of your testimony?

16

17 A3. The purpose of my testimony is to comment on the
18 subject of cost and its relationship to pricing as
19 discussed in the testimonies of Dr. Cornell and
20 Dr. Mayo. Specifically, I will address the issues
21 of the use of Total Incremental Cost and Average
22 Incremental Cost for establishing minimum pricing,
23 the appropriate role of sunk costs for prices, the
24 "building block" approach to costing and pricing,
25 and the proposal that equal rates be charged for